Information from the Division of Health Care Finance and Policy

# Quarterly Acute Hospital Financial Report, FY06 Q2

*In FY06 Q2, hospital industry profitability improved; approximately 72% of hospitals experienced positive Total Margins versus 63% in the first quarter. In addition, this percentage was generally stable compared to the second quarter of the previous year. Further, a large majority of the industry (80%) was comfortably able to meet short-term obligations, and accounts receivable and payment periods continued to improve for the most part. Finally, decreasing equity financing values indicate additional debt financing for hospitals, while the ability to cover long-term obligations remained a serious concern for 35% of Massachusetts hospitals.*

## About this Report

The Division of Health Care Finance and Policy (the Division) publishes quarterly acute hospital financial reports in response to a legislative mandate to provide an annual assessment of financial trends in the acute care hospital industry. Quarterly reporting is one part of the Division's ongoing program to better protect the public interest by continuously monitoring the financial condition of acute care hospitals. This report presents an industry-wide analysis from FY02 through FY06 Quarter 2 (Q2).[1,2] Financial trends for individual hospitals are on each hospital's Fact Sheet in the DHCFP Data Catalog at www.mass.gov/dhcfp.

Trends in financial ratio analysis can provide useful information about the hospital industry's financial condition. The three areas examined on a quarterly basis and discussed in this report are profitability, liquidity, and solvency.[3]

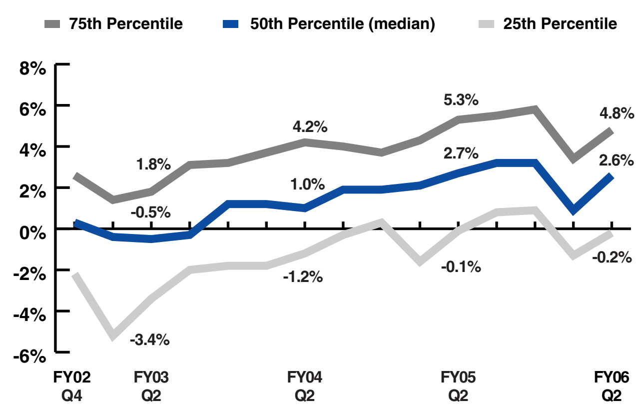
## Profitability

Although most Massachusetts acute care hospitals are non-profit, they do need to generate a sufficient surplus in order to complete their missions, repay debt, and invest in the future of their organizations. Therefore, an analysis of the industry's profitability using three key ratios is reported here. Figures 1, 2, and 3 show FY02 through FY06 Q2 trends for 25th, 50th (median) and 75th quartile values[4] for Total Margin,[5] Operating Margin,[6] and Non-operating Margin.[7]

Profitability levels improved markedly in FY06 Q2 (see Figures 1 through 3) for all three quartiles when compared to the first quarter and were fairly stable for the lower two quartiles when compared to the same quarter of the previous year. Operating margin, slightly below FY05 Q2 levels for the upper two quartiles, improved markedly when compared to FY06 Q1. Non-operating margin improved for all three quartiles in FY06 Q2 when compared to the first quarter. For reference, Figure 4 provides annual measures of total profitability.

**Figure 1**

**Total Margin Trend by Quarter, FY02-FY06 Q2**




- **Following a predictable dip in the first quarter, overall profitability improved in FY06 Q2 across all three quartiles, and was generally stable when compared to the same quarter of the previous year.**



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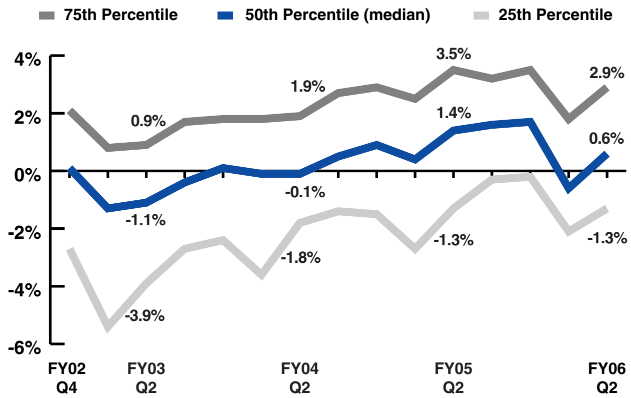
**Figure 2**

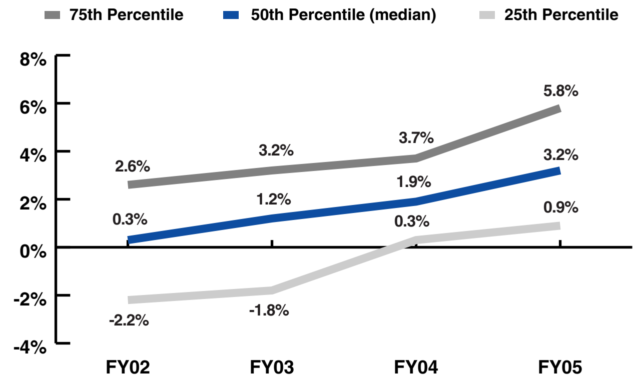
## Operating Margin Trend by Quarter, FY02-FY06 Q2




- **As expected, hospital operating performance improved across all three quartiles in FY06 Q2 compared to FY06 Q1, but was slightly lower for the upper two quartiles when compared to FY05 Q2.**

**Figure 4**

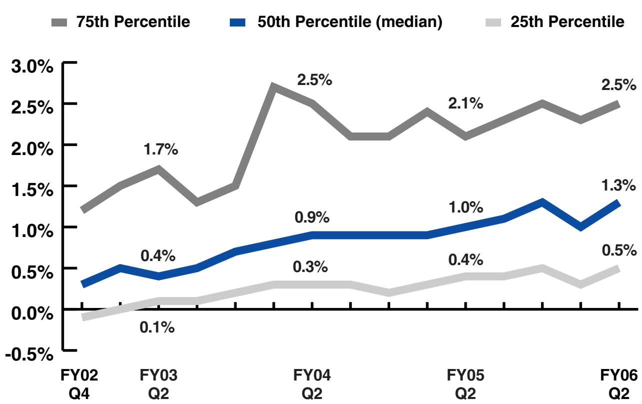
## Annual Total Margin, FY02-FY05




- **Annual Margins are provided as a reference.**

**Figure 3**

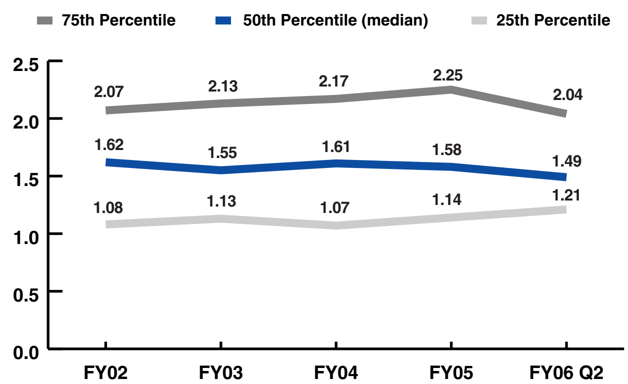
## Non-operating Margin Trend by Quarter, FY02-FY06 Q2




- **Non-operating margin improved for all three quartiles in FY06 Q2 compared to FY06 Q1, and was higher when compared with the second quarter of FY05. Only five hospitals reported non-operating losses in FY06 Q2.**

**Figure 5**

## Current Ratio Trend, FY02-FY06 Q2




- **Compared to FY05, Current Ratio decreased for the upper two quartiles, but improved for the lower quartile in FY06 Q2. More than 80% of the industry maintained a Current Ratio above the 1.0 benchmark in the second quarter.**

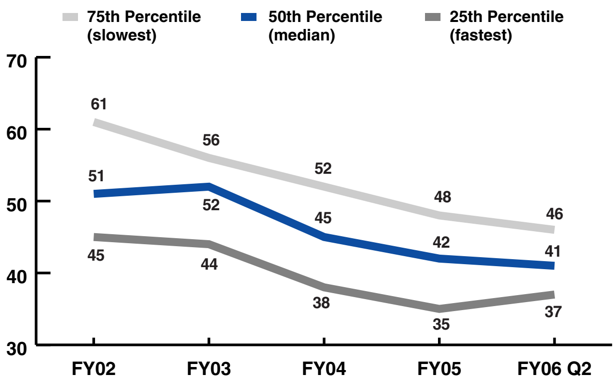
## Liquidity

Liquidity ratios indicate a hospital's ability to meet its short-term obligations. Deterioration of these ratios is one indication of financial stress. Three liquidity ratios are reported here: Current Ratio,[8] Average Days in Accounts Receivable (A/R),[9] and Average Payment Period.[10] Figures 5, 6, and 7 show trends in quartile values for these three ratios.

Compared to FY05, the majority of hospitals demonstrated a slightly lower ability to meet current obligations in FY06 Q2; nevertheless, a large majority (80%) of hospitals operated

**Figure 6**

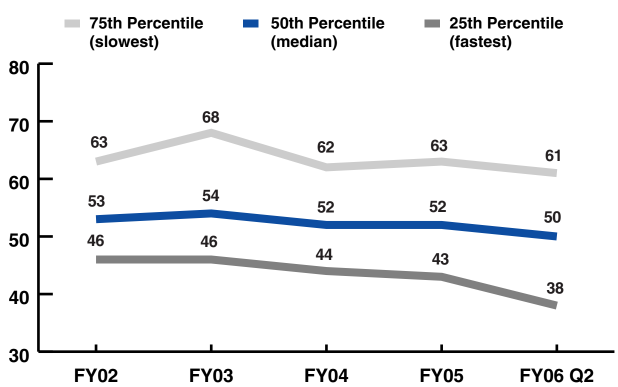
## Days in Accounts Receivable Trend, FY02-FY06 Q2




- **Following the industry's positive trend since FY02, hospitals continued to improve collection of receivables in FY06 Q1. Median Days in A/R decreased by two days over FY05.**

**Figure 7**

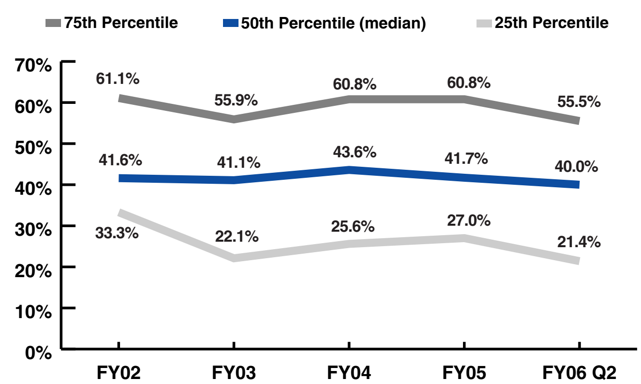
## Average Payment Period Trend in Days, FY02-FY06 Q2




- **Average Payment Period decreased across all quartiles in FY06 Q1; however, close to 30% of hospitals paid current obligations at a faster rate than they collected receivables.**

**Figure 8**

## Equity Financing Trend, FY02-FY06 Q2




- **Equity Financing Ratios decreased slightly for all three quartiles in FY06 Q2. Further, 35% of the hospitals were below the 30% benchmark. The highly leveraged position of these hospitals may make future asset acquisition difficult for this group.**

above the 1.0 minimum benchmark (see Figure 5).[11] In addition, although the lower quartile gained 2 days in Accounts Receivables, the majority of the industry showed more efficient management of Days in A/R (see Figure 6). Similarly, the industry showed continued improvement across all quartiles in the average time to pay current liabilities (Average Payment Period, see Figure 7). Close to 30% of hospitals, however, are paying current obligations at a faster rate than they are collecting payments; this could lead to cash flow constraints for this group of hospitals in the future.

## Solvency

Solvency ratios provide information regarding both how an organization finances its assets and how able an organization is to take on new debt. Deterioration of these ratios is another indication of problems in the financial health of an organization. Solvency ratios of Debt Service Coverage and Cash Flow to Total Debt are not included in this report because annualized data are necessary to accurately present these ratios. For quarterly analysis, only one solvency ratio is reported: Equity Financing.[12]

The Equity Financing ratio, measured by the proportion of total assets financed by equity, reflects the ability of a hospital to take on more debt. Low values indicate that a hospital is highly leveraged and could have difficulty securing access to debt financing for further asset acquisition. Equity financing decreased slightly for all three quartiles in FY06 Q2, but is above the benchmark for the upper and middle quartiles. The decrease may signal increased long-term debt as hospitals refurbish, add new services, and buy or lease new equipment. Equity Financing, however, was below the 30% industry benchmark for 35% of the hospitals, indicating long-term solvency issues for this group.

## Teaching versus Non-teaching Hospitals

The Division also examines the financial health of teaching and non-teaching hospitals using financial ratio analysis. In terms of total and operating profitability, teaching hospitals outperformed non-teaching hospitals, with a lower percentage of teaching hospitals experiencing overall losses. In terms of non-operating performance, teaching hospitals showed higher levels of non-operating gains; however, a much larger percentage (19%) of teaching hospitals experienced non-operating losses (albeit small) compared to non-teaching hospitals (4%).

Results were mixed with regard to liquidity. Although Current Ratio was slightly higher for teaching hospitals in the upper and lower quartiles, only three teaching hospitals and 10 non-teaching hospitals operated below the minimum industry benchmark of 1.0. Teaching hospitals, however, increased their Days in A/R and Average Payment Period, while non-teaching hospitals remained fairly stable on Accounts Receivable, and improved over FY06 Q1 in paying current obligations.

Non-teaching hospitals may have more difficulty borrowing in the upcoming year as 39% (versus 25% for teaching hospitals) were below the 30% benchmark for Equity Financing in FY06 Q2. For non-teaching hospitals, this represents a 5% increase over FY05 in the percentage of hospitals below the benchmark.

## Summary

As expected, overall profitability improved in FY06 Q2 relative to Q1, and the percentage of hospitals with negative margins decreased as well. Total profitability was also generally stable when compared to FY05 Q2. Although Current Ratio was slightly lower in the upper two quartiles relative to FY05, a large majority of hospitals (80%) were still able to meet their current obligations. In addition, management of receivables for the most part improved across the industry, as did payment period. Finally, equity financing was slightly lower than FY06 Q1 and FY05 levels, indicating an increase in debt financing for asset acquisition. In addition, the ability to cover long-term obligations remained a serious concern for 35% of the industry.

Financial ratio values for each hospital are on the Hospital Fact Sheets in the Division of Health Care Finance and Policy Data Catalog at www.mass.gov/dhcfp. Hospital-specific dollar surplus or loss, net patient service revenue, total net assets, and assets whose use is limited are also provided on the Hospital Fact Sheets illustrating the magnitude of hospital surplus and loss, the size of operation, and the size of reserves.

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[1] The FY06 Q2 findings in this report are based on the financial filings of 65 acute care hospitals. One hospital (Mercy Medical Center) has a fiscal year that ends on December 31st, thus FY06 Q2 data represent only the first quarter of the fiscal year. Three hospitals (Cambridge Health Alliance, Metrowest Medical Center and St. Vincent Hospital) have fiscal years that end on June 30; therefore these hospitals' data represent the first three quarters of operation. Martha's Vineyard Hospital's fiscal year ends on March 31, thus its FY06 Q2 data represent the full fiscal year. Falmouth Hospital had not filed its FY06 Q2 filing at the time of this analysis and is therefore not included in this report.

[2] *The AICPA Accounting and Audit Guide for Health Care Organizations* has changed the method of accounting and auditing for Alternative Investments. Where a hospital holds a 5% or greater ownership of such investments, the hospital must report these investments using the Equity Method. The effect of using the Equity Method is that income or losses from these investments are reported as non-operating gains (losses), as opposed to a change in net assets.

[3] Depending on the organization of each hospital, data may exclude other aspects of some hospitals' financial health, such as performance of endowments or the financial health of parent or other affiliated organizations.

[4] Quartile values can shed light on information about the distribution of financial ratio values across hospitals. Often, averages can be materially affected by outlier/extreme values at the low and high ends of a distribution. Examining quartiles, therefore, is a preferred means of assessing the overall distribution of values across hospitals. For instance, the ratio values of one-quarter of the hospitals at the low end of the distribution will fall at or below the 25th quartile value. Similarly, the ratio values of one-quarter of the hospitals at the high end of the distribution will fall at or above the 75th quartile value. The 50th percentile is the median, or the center of the distribution of values. Half of the hospitals' financial ratio values will fall below the median, and half will fall above the median. These quartile measures are particularly useful when a distribution is markedly skewed, or where it is generally symmetrical but includes a few outliers.

[5] Ratio of total income to total revenue.

[6] Ratio of operating income to total revenue.

[7] Ratio of non-operating income to total revenue.

[8] Ratio of current assets to current liabilities.

[9] Ratio of net patient accounts receivable to net patient service revenue/quarters of data * 91.25.

[10] Ratio of current liabilities less estimated third-party settlements to total expenses less depreciation and amortization/quarters of data * 91.25.

[11] A Current Ratio value of 1.0 indicates that a hospital has one dollar held in current assets per dollar of current liabilities. Values below 1.0 are considered strongly unfavorable and highlight an organization's illiquid position.

[12] Ratio of total net assets to total assets.



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